#### EX PARTE OR LATE FILED

Anna-Maria Kovacs First Vice President-Research Janney Montgomery Scott 60 State Street Boston MA 02109

Mr. Andrew Fishel Managing Director Federal Communications Commission 1919 M Street NW, Room 852 Washington DC 20554

Con Co of Secretary

organisms Comquession

April 8, 1997

EX PARTE:

Access Charge Reform CC Docket 96-262

Federal State Joint Board on Universal Service CC Docket 96-45

Dear Mr. Fishel,

On February 26, 1997 a group of financial analysts, Frank Governali of Credit Suisse/First Boston, Richard Klugman of Goldman Sachs, Peter Kennedy of Morgan Stanley, Charles Shelke of Smith Barney, and I, met with Tom Boasberg, Robert Pepper, Greg Rosston, Jon Garcia, Elliot Maxwell, of the FCC staff and FCC Chairman Reed Hundt to discuss recent presentations by telecommunications companies to Wall Street analysts and investor expectations of upcoming regulatory decisions in the access charge reform and universal service dockets listed above. I have enclosed copies of the publications that the analysts issued subsequent to the meeting. In accordance with the Commission's rules, an original and two copies of this notice are being filed.

Please let me know if you have any questions.

Sincerely yours,

And Harry Torce

#### **Morning Meeting Comments**

FEBRUARY 27, 1907

TELECOM UNDUSTRY

LIPCATE

anna-maria Koyace Kristin Burne Telecom industry Five self-side analysis, including myself, met yesterday, briefly, with Chairman Hundt, and at much granter length with his staff. The goal of the meeting was to get Wall Street's reaction to the PCC's current thinking about access reform and universal service, and specifically to test our reaction to the ideas in Chairman Hundt's speech to NARUC on February 25\*.

In his speech, Cheirman Hundt reiterated the principles of the August Interconnection Order and focused on some of the specific items that had been raised in the speece Notice of Proposed Rulemaking (NPRM, 12/24/96). He stated that he considers infrastructure competition most desirable, and believes the best way to achieve that is to enable new entrants to share incumbents' facilities via resale, unbundling, and interconnection. He reaffirmed his commitment to universal cervice, and his belief that access reform must be done simultaneously with universal service. Specifically he stated:

While he does not believe in separate federal and state Punds; he is inclined to avoid jurisdictional litigation by focusing the federal Universal Service Pund (USF) on interestate revenues only. We believe that is likely to result in a fairly small federal USF and to be helpful to companies like Ameritech that are not contributers to the Pund, and not helpful to others like Bellicousiver GTE that are large not takers from the Pund. He continues to be committed to restructuring access charges in accordance with underlying costs, converting fixed costs currently recovered on a per-minute basis to flat rates. He suggested the name PERC, flat equitable rate charge, for the flat rate. He suggested that it might be imposed more quackly or to a greater degree on second residential lines or on multibusiness lines than on first residential lines.

He asked for comment on speed of transition in moving access charges to forward looking costs, and indicated that it might make sense to move to a market-based system more rapidly on originating traffic, where the consumer has a choice about his local carrier than at the terminating end, where the consumer is at the mercy of someone else's choice. He also indicated that initial access rate cuts at the originating end south be smaller than at the terminating end.

Like the accres cuts, the USF may be phased in. In considering recovery of embedded costs in this simultaneous process, he believes the profits local companies make from, wireless, publishing and long-distance should be considered as offsets to the "takings" from the care business.

He also commented with regard to Bell in-region long distance unity (section 271 entry) that he looks to the states for a record on competition in the state and that "The quality of the record compiled by each state commission may be more important than the vote that commission casis."

The self-side group, almost all of whom currently are recommending RBOCs and other LBCs rather than major long distance players, was asked to comment on several points specifically:

On our expectations for the financial magnitude of access cuts tiet of USF funding by DCCs: everyone seems to expect an initial cut of \$1-2 billion in year one, with similar cuts for several years, for a total of \$7 billion in 5 years. No one in the group would change ratings over an initial cut of \$3 billion, as long no the 5 year total remains the same or less.

This beforessells in each types for interruptive payagest only one is no executional to a supercurption by us or for its set or published of an all in the payagest the best parameters by us or for its payagest or an allowing the payagest of an execution of an execution

104161 HONIACHEM MATI

On the FERC: all feel that the ability to flat-rate per minute charges would be helpful to AT&T and other DCCs as long as they could pass the charge through any way it wants. It would enable it them to lower per-minute rates, which is helpful to high-end users, and place a flat charge of small users. We also agreed that passing the PERC through the long-distance bill is likely to result in more protest from consumers than passing it through the local bill, since many consumers make little use of long distance. Our group agreed that raising the SLC would be unpopular with Congress but felt it would work better with consumers themselves.

The group was split on our expectations of when 271 entry would occur, with most of us expecting most of the entry in '96. The supporters of Bell stocks were clear that their support of those stocks relies most on their belief that significant competition in the local market will develop slowly, much more slowly than the Bells' entry into long distance in-region.

What we believe the FCC took away from the meeting was a same that access duts in the \$1-3 billion range this year would be accepted calmly by the stock market, and that the FERC would be good for both local teleos and long distance carriers, but not for pure CAPs.

We continue to expect initial access cuts in the \$1-2 billion range, not of universal service funding. They may well focus more on the terminating than originating end. We expect additional prescriptive cuts over the next several years unless the market itself takes down access rights significantly. We expect a small federal USP.

We continue to recommend purchase of AT&T (T-\$41).

### Morning Meeting Comments

FEDRUARY 27, 1967

TELECON MIDUSTRY

LIBBATI

Anna-Mària Koyace Kristin Burne Telecom industry Five self-side analysis, including myself, met yesterday, briefly, with Chairman Hundt, and at much greater length with his staff. The goal of the meeting was to get Wall Street's reaction to the PCC's current thinking about access reform and universal service, and specifically to test our reaction to the ideas in Chairman Hundt's speech to NARUC on February 25°.

In his speech, Cheirman Hundt reiterated the principles of the August Interconnection Order and focused on some of the specific items that had been raised in the species Notice of Proposed Rulemaking (NPRM, 12/24/96). He stated that he considers infrastructure competition most desirable, and believes the best way to achieve that is to enable new entrants to share incumberts' facilities via resale, unbundling, and interconnection. He reaffirmed his commitment to universal cervice, and his belief that access reform must be done simultaneously with universal cervice. Specifically he stated:

While he does not believe in separate federal and state Punds; he is inclined to avoid jurisdictional litigation by fecusing the federal Universal Service Pund (USF) on interestate revenues only. We believe that is likely to result in a fairly small federal USF and to be helpful to companies like Americach that are not contributers to the Pund, and not helpful to others like BellSouther GTE that are large net takers from the Pund. He continues to be committed to restructuring access charges in accordance with underlying costs, converting fixed costs currently recovered on a per-minute basis to flat rates. He suggested the name PEEC, flat equitable rate charge, for the flat rate. He suggested that it might be imposed more quackly or to a greater degree on second residential lines or on multibusiness lines than on first residential lines.

Me asked for comment on speed of transition in moving access charges to forward looking costs, and indicated that it might make sense to move to a market-based system more rapidly on originating traffic, where the consumer has a choice about his local carrier than at the terminating end, where the consumer is at the mercy of someone else's choice. He also indicated that initial access rate cuts at the originating and anight be smaller than at the terminating and.

Like the access cuts, the USF may be phased in. In considering recovery of embedded costs in this simultaneous process, he believes the profits local companies make from, wireless, publishing and long-distance should be considered as offsets to the "takings" from the core business.

He also commented with regard to Bell in-region long distance unity (section 271 entry) that he looks to the states for a record on competition in the state and that "The quality of the record compiled by each state commission may be more important than the vote that commission casis."

The self-side group, almost all of whom currently are recommending RBOCs and other LBCs rather than major long distance players, was asked to comment on several points specifically:

On our expectations for the financial magnitude of access cuts side of USF funding by DXCs: everyone seems to expect an initial cut of \$1-2 billion in year one, with similar cuts for several years, for a total of \$7 billion in \$ years. No one in the group would change ratings over an initial cut of \$3 billion, as long as the 5 year total remains the same or lose.

This belowates in restriction for before groups only used to no count should be construct as a representation by us or for jos other to an electrical of an allow in terms or country. The label the best properties by the strength of the best properties by on an instance of the properties of the properties by the strength of the properties of the propert

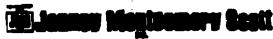
On the FERC: all feel that the ability to flat-rate per minute charges would be helpful to AT&T and other DXCs as long as they could pass the charge through any way it wants. It would enable it them to lower per-minute rates, which is helpful to high-end users, and place a flat charge of small users. We also agreed that passing the PERC through the long-distance bill is likely to result in more protect from consumers than passing it through the local bill, suce many consumers make little use of long distance. Our group agreed that raising the SLC would be unpopular with Congress but felt it would work better with consumers themselves.

The group was split on our expectations of when 271 entry would occur, with most of us expecting most of the entry in '96. The supporters of Bell stocks were clear that their support of those stocks relies most on their belief that significant competition in the local market will develop slowly, much more slowly than the Bells' entry into long distance in-region.

What we believe the PCC took away from the meeting was a sense that access cuts in the \$1-3 billion range this year would be accepted calmly by the stock market, and that the FERC would be good for both local teleos and long distance carriers, but not for pure CAPs.

We continue to expect initial access cuts in the \$1-2 billion range, not of universal service funding. They may well focus more on the terminating than originating end. We expect additional prescriptive cuts over the next several years unless the market itself takes down access rights significantly. We expect a small federal USP.

We continue to recommend purchase of AT&T (T-\$41).



#### Morning Meeting Comments

PERRUARY 27, 1967

ANNA-MARIA KOVACE KRESTIN BURNE TELECOM INDUSTRY

Five self-side analyses, including myself, met yesterday, briefly, with Chairman Hundt, and at much granter length with his staff. The goal of the meeting was to get Wall Street's reaction to the PCC's current thinking about access reform and universal service, and specifically to test our reaction to the ideas in Chairman Hundy's speech to NARUC on February 25°.

In his speech, Cheirman Hundt reiterated the principles of the August Interconnection Order and focused on some of the specific items that had been raised in the speeds Notice of Proposed Rujemaking (NPEM, 12/24/96). He stated that he considers infrastructure competition most desirable, and believes the best way to achieve that is to enable new entrants to share incumbents' facilities via resale, unbundling, and interconnection. He reaffirmed his commitment to universal corvice, and his belief that access reform must be done simulaneously with universal service. Specifically he stated:

While he does not believe in separate federal and state Punds; he is inclined to avoid jurisdictional litigation by focusing the federal Universal Service Pand (USP) on interestate revenues only. We believe that is likely to result in a fairly small federal USF and to be helpful to companies like Ameritach that are net contributers to the Fund, and not helpful to others like belificutivor GTE that are large net takers from the Fund. He continues to be committed to restructuring access charges in accordance with underlying costs, converting flued coe's currently recovered on a per-minute basis to flat rates. He suggested the name FBBC, flat equitable rate charge, for the flat rate. He suggested that it might be imposed more quickly or to a greater degree on second rasidantial lines or on multibusiness lines than an first residential lines.

He asked for comment on speed of transition in moving access charges to forward looking costs, and indicated that it might make sense to move to a market-based system more rapidly on originating traffic, where the consumer has a choice about his local carrier than at the terminating end, where the consumer is at the mercy of someone else's choice. He also indicated that initial access rate cuts at the originating and stight be smaller than at the terminating and.

Like the access cuts, the USP may be phased in. In considering recovery of embedded costs in this simultinescus process, he believes the profite local companies make from, wireless, publishing and longdistance should be considered as offsets to the "takings" from the care business.

He also commented with regard to Bell in-region long distancementry (section 271 entry) that he looks to the states for a record on competition in the state and that "The quality of the record compiled by each state commission may be more important than the vote that commission casts."

The self-side group, almost all of whom currently are recommending RBOCs and other LBCs rather then major long distance players, was asked to comment on several points specifically:

On our expectations for the financial magnitude of access cuts tidt of USF funding by IXCs: everyone poorne to expect an initial cut of \$1-2 billion in your one, with similar cuts for several years, for a total of \$7 billion in 5 years. No one in the group would change ratings over an initial out of \$3 billion, as long no the E year total remains the same or less.

JAMEY MONTGOMERY SCOTT

PERMANY 27, 1867

On the FERC: all feel that the ability to flat-rate per minute charges would be helpful to AT&T and other DXCs as long as they could pass the charge through any way it wants. It would enable it them to lower per-minute rates, which is helpful to high-end users, and place a flat charge of small users. We also agreed that passing the PERC through the long-distance bill is likely to result in more protest from consumers then passing it through the local bill, since many consumers make little use of long distance. Our group agreed that raising the SLC would be unpopular with Congress but felt it would work better with consumers themselves.

The group was split on our expectations of when 271 entry would occur, with most of us expecting most of the entry in '96. The supporters of Bell stocks were clear that their support of those stocks relies most on their belief that significant competition in the local market will develop slowly, much more slowly than the Bells' entry into long distance in-region.

What we believe the PCC took away from the meeting was a same that access cuts in the \$1-3 billion range this year would be accepted calmly by the stock market, and that the FERC would be good for both local teleos and long distance carriers, but not for pure CAPs.

We continue to expect initial accese cute in the \$1-2 billion range, not of universal zervice funding. They may well focus more on the terminating than originating end. We expect additional prescriptive cuts over the next several years unless the market itself takes down access rights agnificantly. We expect a small federal USF.

We continue to recommend purchase of AT&T (T-\$41).



# MORGAN STANLEY Equity Research Briefing Note

## AFT, BEL., BLS. FON. GST, ICIX, ICIG, IDIC, MCIC, MCLD. NYN, PAC, SBC, T, TCGI, USW. WCII, WCOM. US
Telecommunications Services (I/TEL): Meeting With the PCC
Stephanic Comfort (303) 740-6695
Puter Kennedy (212) 761-8033

Date: March 5, 19

Date: March 5, 1997 Type: Industry Overview

#### KEY POINTS

Yesterday we met with the PCC to discuss access reform and universal service. The PCC was looking for Wall Servers expectations and reactions to various outstance.

Although the process is still field, we believe this meeting combined with our incorporation of Chairman Reed Flundt's recent speech to the National Association of Regulatory Utility Commissioners has given us a better sense, directionally, of where the Commission is going.

As you recall, the 1996 Telecom Act required that the Universal Fund, an explicit subsidy fund, he enhanced to support intercommunications services for low income households, high cost areas and subsidize public schools, libraries etc. Today these rebaidies are primarily achieved through implicit support mechanisms (access revenues). The goal of the PCC has been to testructure the support mechanisms from implicit to asplicit subsidies. This is why access referen and universal service are so interwined.

#### Access Referent.

According to PCC reports, in 1995 them was \$31% for in secess charges poid to the local exchange providers. This consists of \$7.1% in endants revenue with the remaining \$24h from switched and special access. Switched access revenues are derived from originating and terminating per minute access charges paid by the inter exchange carriers (DCCs). Today, traffic assettive access rates are just below \$0.03 per minute. These access rates have historically never been based on cost but have been used to subsidize other high cost components of the local network. The FCC intends to drive inter-state access pass down to cost over some time period. With supress estimates for forward

looking economic come coming in at \$0.004-\$0.01. There is a significant gap between current teriffs and dost project has.

We halive this reform will be realized through two methods, restructuring and straight subscions.

Assired suring - One of alternatives mentioned was to convent variable carrier common line (CCL) charges into fixed line charges. A parties of access rans today (\$0.004-\$0.02) are what are known as carrier common line charges. These charges were created to support the high cost of the local loop. Although the charges are traffic sensitive, the actual costs are not traffic sensitive and should indeed be a fixed cost. Instead of paying a per minute charge, LD providers will pay a fixed cost per pre-subscribed litte.

#### Implications

- We biliove this benefits Long Distance Providers aspecially those with high and customers. By plening a greater portion of variable cost into fixed costs.

  Interest hange providers will be able to offer price incentives to stimulate volume demand while kneping a greater person of the casts fixed,
- For the CLECS, we believe this is slightly negative in the short to m. By placing more of the revenue into fixed put line revenues, it distactors the cream attimming of high end many.
- This restructuring is slightly favorable for the RBOCs because this does dislacent crum skimming but it also reduces the benefit of access volume growth in the activoris.

Reductions -

This memorandum is based on inferrention resiliable to the public. No reprocuestion is inside time is in samples or complete. This memorandum is not an office to buy or sell or a callclusting of an office to buy or sell the translations resolvened. He organ Stanley & Co. Inc. and others memorand with it may have positions in and office translations in exemples of companies remained and may also prefer or such to purfect investment healthing vary are for those companies.

28.60

#### **MORGAN STANLEY**

We also believe there will be subtracted reducedors in access rates driving the staffic sensitive parties down to \$0.005-\$0.01 range over the next date to five years. We believe that those rates will be reduced through a combination of regulatory cuts and prescribed minimums for market based reduction, with particular emphases on terminating access.

#### Implications

- Again this is a positive for the long distance providers to the extract retail prices remain sticking and do not decline as fast as second.
- For the CLECs this is a slight negative because of their conditional CAP business which relied heavily on access rame. The CLEC or Dial tone business is less improved because of the diverse revenue streams of lotal, roll and second.
- The RBOCs should feel pressure from any eignificant cuts in assess. It is their most profitable revenue, with 10% + margins. To the exact that the excess reductions are not supplemental with Universal Service payments, these reductions will vigtually all fall to the bottom line.

#### Universal Service Fund

The exact size of the final has yet to be determined, but it appears to be substantially less than the present implicit fund. Currently the Commission estimates that there is \$23B in access charges that are flowing to Incumbent local exchange carriers (ILBCs) from DICE. The consection that has arisen is how much of the access revenues go towards real costs and how large should the new explicit subsidy be. The ILBCs believe they should be large whole or close to whole, while the DICEs think the explicit fund should be \$5-10B. We believe the Sueet is anticipating the fund will end up in the \$10B-15B.

The PCC is currently in negociations with the State PUCs on just how to approach the fixed. Will there be two separate funds (Intra-state and Interstate) or one large universal fund? The PCC's position today, is that unless there is consensus among the States, the PCC will just run an interstate universal fund and let the States find for themselves on the shortfalls. We believe the PCC is a bit sky after the States

lawrence over the interconnection rules but we also believe this is a bit of postering by the PCC. The rural states with less telecommunications revenues and higher coars structures would be better off with one Federal Found. Because of the revenue concentration in the top 10 states, we believe that the majority of States would benefit from one control fund.

Fixed Charge - With the reductions in access, the FCC has to derive another payment mechanism to support the universal fund. The mechanism that is currently being discussed is a flat rate, called the flat and equitable race charge (FSRC), based on pre-subscribed lines. The charge will probably not be equal for all lines, multi-lines and second lines will probably have promises attached.

FCC uses Interstate Revenues to Fund the Faderal Portion of Universal Funds. If the FCC goes with only Interstate revenues, no local or intrastate revenues will be affected (taxael) by the FCC Fund.

#### Not Inches

If the PCC remains on its present track, with the interstate fund only, we could see the ILECs' subsidy pool strink by SSB to 108 over the next five years. This does not account for any clasticity/growth in the matiest or any State support machanisms.

#### LD

LD players appear to be the winners in access referm.

Although the timing and unagainede is still unclear, we believe that not payments to the ILECS will decline.

#### CLEC

We see the impact to the CLECs as slightly negative but above expectations. The CLECs will be impacted by access reductions, but these reductions will be phased in and will be more focused on the terminating access reductions which impact the ILECs more than the CLECs. In regards to universit services contributions, if the FCC decides on an interstate fund only, CLECs will not have to contribute any revenues from its core base. These CLECs with a large portion of ILD revenues will be beneficiaries of this reform.

This memorantum is hand on information training to the public. No representation is made that it is execute or complete. This memorantum is not an effect to buy or still or a solicitation of an office to buy or still or a solicitation of an office to buy or still or a solicitation of an office to buy or still or a solicitation of an office to buy or still or a solicitation of companies mentioned and may also perform or make to perform invariants bandling services for those companies.

#### ILEC

Access rate reductions should set into profitable inventors with an complete offset by universal service. RBOCs will need to roly on States for rebalancing or mass run universal service funds. On the positive side, the market was eating into the high end business access and would overmally bring down rates with no tebulancing. Flat runs will case some of the create stimuming.

Table 1
Pennils Elements of Access Charge Reform and Universal Scivice Fund Proposal From FCC

Possible Processi	] IRC	Implications Long Dige	CURC
(1) Account endoctors will be a combination of an uplant, out (pamily) \$1-92 billion) and a machanism to drive down account to over a pur-decembed guided of time (i.e. 3-5 yes)	negative test tests: a. State end	posidvě	tegative (but hearer than a flock out)
(2) As means charges are delvine down, some varye based charges due to USCs conventy remotes from long distance another will be exercised to the juic charge.	padise 	puláve	Marin
(7) The translating execut charges could be deliver down factor than eniginality excess observe down in grown market presents. (se compatition) on originality than on terminality terms (sections: don't observe the translations don't observe the translations.)		<b>pacitive</b>	positive
(4) The PCC is equalizating remaining just an interestive registered service that which would be smaller than oursely expected. Investigate to per the individual stream to deal with the interestive position of the figure.	mgad**	postdva	padin
Nag Nac	Negative	Postdve	Nested, Industrial teach associated age seeding age

This westpomptum is based on information evaluate to the public. No representation is time that it is assume or complete. This memorandum is not on effect to large or salinization of an effect the salinization of entered and may also perfect to perfect investment landing salvices for these companies.



# MORGAN STANLEY Equity Research Briefing Note

WAIT, BEL. BLS. FON. GST, ICIX, ICIG, IRIC, MCIC, MCLD. NYN. PAC, SBC, T, TCGI, USW. WCII, WCOM. US
Telecommunications Services (I/TEL): Meeting With the PCC
Stephanic Confect (303) 740-6695
Peter Kennedy (212) 761-8033

Date: March S, 1

Date: March 5, 1997
Type: Industry Overview

#### REA LOIMIZ

Yesterday we met with the PCC to discuss access reform and universal service. The PCC was looking for Wall Servers expectations and reactions to various outstmen.

Although the process is still fluid, we believe this meeting combined with our interpretation of Chaleman Reed Hundt's recent speech to the National Association of Reguletory Utility Commissioners has given us a better nease, directionally, of where the Commission is going.

As you recall, the 1996 Telecam Act required that the Universal Fund, an explicit subsidy fund, he enhanced to support telecommunications services for low income households, high cost areas and subsidize public schools, libraries one. Today these subsidies are primarily achieved through implicit support mechanisms (access revenues). The goal of the PCC has been to metasteen the support mechanisms from implicit to amplicit subsidies. This is why access reform and universal service are so interwined.

#### Access Referen

According to PCC reports, in 1995 there was \$31B for in access charges poid to the local exchange providers. This consists of \$7.1B in enduser revenue with the romaining \$24b from switched and special access. Switched access revenues are derived from originating and terminating perminate access charges paid by the inter-exchange carriers (DICe). Today, traffic assettive access rates are just below \$0.03 per minute. These access that have historically sover been based on cost but have been used to subciding other high next components of the local network. The PCC intends to drive inter-etute access pass down to cost over access time period. With outstact estimates for forward

looking secondaric costs coming in at \$0.004-30.01. There is a significant gap between current mails and cost projections.

We halisve this reform will be realized through two methods, restructuring and straight reductions.

Asserted using - One of alternatives mentioned was to convert variable carrier common line (CCL) charges into fixed line charges. A pertion of accuss trans today (SO-004-50-02) are what are known as carrier common line charges. These charges were created to support the high cost of the local loop. Although the charges are traffic sensitive, the actual costs are not traffic sensitive and should indeed be a fixed cost. Instead of paying a per minute charge, LD providers will pay a fixed cost per pre-subscribed line.

#### Implications

- We biliove this benefits Long Distance Providers sepentially those with high and customers. By placing a greater parties of variable cost into fixed costs, Interest change providers will be able to offer price incentives to stimulate volume demand while keeping a greater parties of the casts fixed.
- For the CLECS, we believe this is alighely negative in the short as m. By placing more of the revenue into fixed per line reviewes, it distancests the cream akimming of high end mark.
- This restructuring is slightly favorable for the RBOCs because this does distanced cream skimming but it also reduces the benefit of access volume growth in the activoris.

Reductions -

This momentum is based on information or the public. No reprospection to bead time is in complete. This momentum is not as affect to buy or pall or a collectation of an office to buy or sail the contribut monitoned. Heregan Stanley & Co. Inc. and others conscious with it may have positions in and office transactions in executions of companies received and may also about to purfects because building various for these

#### MORGAN STANLEY

We also believe there will be substantial reductions in access rates driving the staffic sensitive parties down to \$0,005-\$0.01 range over the next diese to five years. We believe that these rates will be reduced drough a combination of regulatory case and prescribed minimums for market based reduction, with particular emphases on terminating secons.

#### Implications

- Again this is a positive for the long diseases providers to the extent retail prices remain sciolcies and do not decline as fast as eccess.
- For the CLECs this is a slight magnive because of their conditional CAP business which relied heavily on access rame. The CLEC or Diel tone business is less impacted because of the diverse revenue access of lotal, toll and second.
- The RBOCs should feel pressure from any significant cuts in ascess. It is their trees profitable revenue, with 80% + margins. To the exact that the ascess reductions are not supplemental with Universal Service payments, these reductions will victually all fall to the bottom line.

#### Universal Service Fund.

The exact size of the fund has yet to be determined, but it appears to be substantially less than the present implicit fund. Currently the Commission estimates that there is \$23B in access charges that are flowing to Incumbers local exchange carriers (ILBCs) from DKCs. The constant that has arisen is how much of the access revenues go towards real costs and how large should the new explicit subsidy be. The ILBCs believe they should be kept whole or close to whole, while the DKCs think the explicit fund should be \$5-10B. We believe the Suset is anticipating the fund will end up in the \$10B-15B.

The PCC is currently in negatiations with the State PUCs on just how to approach the fined. Will there he two separate funds (Intra-state and Interstates) or one large universal fund? The PCC's position today, is that unless there is consequent smoog the States, the PCC will just run an interstate universal fund and let the States fend for themselves on the shortfalls. We believe the PCC is a bit sky after the States

lawsuits over the interconnection rules but we also believe this is a bit of postering by the PCC. The sural states wish less tele-communications revenues and higher costs structures would be better off with one Federal Fund. Because of the revenue concentration in the top 10 states, we believe that the majority of States would benefit from one control fund.

Fixed Charge - With the reductions in eccess, the FCC has to derive another payment mechanism to support the universal fund. The mechanism that is currently being discussed is a flat rate, called the flat and equitable rate charge (FBRC), based on pre-subscribed lines. The charge will probably not be equal for all lines, multi-lines and second lines will probably have premiums attached.

FCC uses Incurate Revenues to Fund the Federal Portion of Universal Funds. If the FCC goes with only Interstate revenues, no local or intrastate revenues will be affected (mand) by the FCC Fund.

#### Not Impact

If the PiC remains on its present track, with the interstant fund only, we could see the ILECs' subsidy pool strink by SSB to \$10B over the next five years. This does not account for any flasticity/growth in the matiest or any State support machanisms.

#### LD

LD players appear to be the winners in access referm.

Although the timing and unagnizeds is still unclear, we believe that not payments to the ILECS will decline.

#### CLEC

We see the impact to the CLEC's as slightly asymtic but above expectations. The CLEC's will be impacted by access reductions, but these reductions will be phased in and will be more focused on the terminating access reductions which impact he ILEC's more than the CLEC's. In magnitude the universal services contributions, if the FCC decides on an internal fund only, CLEC's will not have to contribute any revenues from its core base. These CLEC's with a large portion of LD revenues will be beneficiaries of this reform.

This reconstructum is based on information available to the public. No representation is under that it is accusts or complete. This magnetistance is not unaffect to buy or sell or a sufficient of an office to buy or sell the accusions mentioned. Alongon Studies & Co. lee, and others associated with it may have positions to and affect transactions in associated of companies stunctional and may along perform ay and, so perform investment healting survices for those communities.

#### ILECs

Access rate reductions should ent into profitable invenues with me complete offset by industrial service. RBOCs will need to roly on States for rebalancing or state run universal service funds. On the positive side, the market was enting into the high and business access and would evenually bring down rates with no tebulancing. Plat rams will case some of the cream skinesing.

Table 1
Pensible Elements of Access Churye Reform and Universal Scivice Fund Proposal From FCC

Possible Present	SLEC	Implications Long Dist	C.R.
(1) Access enderdung will be a combination of no uplement out (passibly \$1-\$2 billion) and a mentageing to drive down access to cost over a purchassessional posical of view (i.e. 3-5 yet)	negative rectiming them a flesh earl	posidvo	tegative (bug hepter date a flark mel)
(2) As accuss sharpes and drives drives, some sample hased classifies due the ELSCs community province from long distance constant will be convenied to fine-paint charges.	padéve	puldve	mpire
(2) The translating meant chapper and it to drive down fatter than originating necess obergus alone there is government; present to comparison on originating than on terminating species (nutritions don't observe with tegralating their calls).	negative:	paristro	pasidve
(4) The PCC is equalizing remains just an instrume universal service than which would be smaller than oursely expected, lawing it up so the individual stage to deal with the instrumer persion of the food.	sepá-	pulive	positivo
Ner Nec	Negative	Posisive	Nestal, inter- tion amusic stenis go auticipolog.

This wemperature is based on information evaluable to the public. No representation is these that it is assurant or complete. This memorand use in use an effort to buy or sell the assurance. In longue Stanley & Co. See, and others associated with it may have positions in and effect transmission in annual part in associated of companies received and may also preferre or well to perform investment heading services for these companies.



# MORGAN STANLEY Equity Research Briefing Note

## AIT, BEL., BLS. FON. GST, ICIX, ICIG, IIXC, MCIC, MCLD. NYN., PAC, SBC, T, TCGI, USW. WCIL, WCOM, US Telecommunications Services (I/TEL): Meeting With the PCC
Stephanic Constort (303) 740-6695
Puter Kennedy (212) 761-8033

Date: March 5, 1

Date: March 5, 1997 Type: Industry Overview

#### KEY POINTS

Yesterday we met with the PCC to discuss access reform and universal service. The PCC was looking for Wall Servers expectations and reactions to various outstants.

Although the process is still fluid, we believe this theoring combined with our interpretation of Chairman Reed Fluidt's recent speech to the National Association of Regulatory Utility Commissioners has given us a better sense, directionally, of where the Commission is going.

As you recall, the 1996 Telecam Ast required that the Universal Fund, an explicit subsidy fund, he enhanced to support telecommunications services for low income households, high cost areas and subsidize public schools, libraries one. Today these subsidies are primarily achieved through implicit support mechanisms (access revenues). The goal of the PCC has been to restructure the support mechanisms from implicit to explicit subsidies. This is why access reform and universal service are go interwined.

#### Access Referen.

According to FCC reputs, in 1995 there was \$31B for in scenes charges poid to the local exchange providers. This consists of \$7.1B in orderer revenue with the remaining \$24b from switched and special access. Switched access revenues are derived from originating and terminating per minute access charges paid by the inter-exchange carriers (DICs). Today, traffic associave access rates are just below \$0.03 per minute. These access terms have historically never been based on cost but have been used to subsidize other high cost components of the local network. The FCC intends to drive inter-expenses access pass down to cost over some time period. With expense estimants for forward

looking scondinic costs coming in at \$0.004-50.01. there is a significant gap between current maille and cost project less.

We halisve this reform will be realized through two methods, restructuring and straight reductions.

Restructuring - One of alternatives mentioned was to conveniversiable carrier common line (CCL) charges into fixed line charges. A parties of accuss trans today (\$0.004-50.02) are what are known as carrier common line charges. These charges were created to support the high cost of the local loop. Although the charges are traffic resultive, the actual costs are not traffic sensitive and should indeed be a fixed cost. Instead of paying a per minute charge, LD providers will pay a fixed cost per pre-subscribed line.

#### Implications

- We bilieve this benefits Long Distance Providers sepecially those with high end customers. By piccing a greater portion of variable cost into fixed costs.

  Intereschange providers will be able to offer prise incentives to stimulate volume demand while knoping a greater partical of the cases fixed.
- For the CLECS, we believe this is slightly negative in the short to m. By placing more of the revenue into fixed put line revenues, it distancests the cream attimming of high and users.
- This restructuring is slightly favorable for the RBOCs because this does distancest cream skimming but it also reduces the benefit of access volume growth in the activoris.

Reductions -

This memorandum is based up information evaluable to the public. No representation is brain that is in assuring or complete. This memorandum is not an offer to buy or sell or a collectation of the offer to buy or sell or a collectation of the offer to buy or sell or a collectation of the offer to buy or sell or a constitute of companies remaining and may also perform or make to purface investment implicing very loss processes.

# MORGAN STANLEY

We also believe there will be substantial reducedous in access rates driving the smills sensitive portion down to \$0.005-\$0.01 range over the next there to five years. We believe that these rates will be reduced through a combination of regulatory case and prescribed minimums for market based reduction, with particular emphases on terminating access.

## Implications

- Again this is a positive for the long dismace providers to the extract retail prices regain stickies and do not decline as fast as secons.
- For the CLECs this is a slight negative because of their unditional CAP business which relied beavily on access rans. The CLEC on Dial name business is less impacted because of the diverse revenue parents of lotal, roll and percent.
- The RBOCs should final pressure from any significant case in access. It is their word perdinable revegue, with 80% + resigned. To the extent that the second reductions are not supplemented with Universal Service payments, these reductions will visually all fall to the bottom line.

# Ohiversi Service Fund

The exact size of the final has yet to be descriziond, but it appears to be substantially less than the present implicit field. Currently the Commission estimates that there is \$238 is access charges that are flowing to incumbent local exchange carriers (ILECs) from DKCs. The contention that has arisen is how much of the access revenues go towards real costs and how large should the new explicit naturity be. The ILECs believe they should be impt whole or class to whole, while the DKCs think the explicit final should be \$5-108. We believe the Steek is esticipating the fund will end up in the \$108-158.

The PCC is currently in negatiations with the State PUCs on just how to approach the final. Will there he two separate funds (facts state and hastetists) or one large universal fund? The PCC's position today, is that unless there is consensus smoog the States, the PCC will just the an integrals universal fund and let the States fixed for themselves on the shortfalls. We believe the PCC is a bit sty after the States shortfalls. We believe the PCC is a bit sty after the States

lawretic lover the interconnection rules but we she believe this is a bit of postering by the PCC. The rural states with less tele-communications revenues and higher come structures would be better off with one Federal Faud. Because of the revenue concentration in the top 10 states, we believe that the majority of States would benefit from one central fund.

Fixed Charge - With the anductions in account, the FCC has to derive another payment mechanism to support the universit fund. The mechanism that is correctly being discussed is a flat run, called the flat and equitable rate charge (FBRC), based on pro-subscribed libes. The charge will probably not be equal for all libes, multi-libes and second is pas will probably have promiums attached.

RCC uses Inscreme Revenues to Fund the Fuderal Portion of Universal Funds. If the FCC goes with only Insertuate revenues, no local or instructor revenues will be affected (named) by the FCC Fund.

## No. I

If the Price remains on its present track with the interpretafund only, we could see the ILECs' subsidy pool shrink by SSB to \$100 over the next five years. This does not account for any charactery/growth in the market or any State support

#### E

LD players appear to be the wieners in access referan.
Authorize the timing and magnitude is still unclose, we believe that met payments to the ELECS will decline.

## E

We see the impact to the CLECs as alightly negative but above expectations. The CLECs will be impacted by access reductions, but these reductions will be pleased in end will be more focused on the terminating access reductions which impact the ILECs more then the CLECs. In regards to universal services contributions, if the FCC ducides on an internal fund only, CLECs will not have to contribute any revenues from its core base. Those CLECs with a large portion of LD revenues will to beautistics of this reform.

This memorantum is based on tofers offer to buy or sell or a subhitudes o positions to seel affect transmisions in on informaton archapte to the public. No chariou of an other to bay or sell the accord a stool is manufate of exampantar panedon manuface is "pade that it is expense or complete, members, interpret Starky & Cs. les, and others at may say share (ordered or mark to perform investment) n. This magnetistate is not us as associated with it play have not healting services for three

#### ILEC

Access two tedistions should est into profitable revenues with no complete offset by universal service. RBOCs will need to rely on States for rebalancing or state the universal service fands. On the positive side, the market was eating into the high end business access and would everywally bring down rates with no rebalancing. Plut rates will case some of the cream skintening.

Table 1
Pensible Elements of Access Charge Reform and Universal Service Fund Proposal From FCC

	ILBC	Implications Long Dist	cusc .
Possible Present  (1) Access codercious will be a combination of an uplimat out (panelly \$1-\$2 billion) and a mechanism to drive down access to cost over a pur-descentional goaled of state (i.e. 3-5 yea)	hagailve has lease than - a flush each	pasid***	tengrative (Iven impact dates a Check mad)
(2) As access charges are driven down, some unique hand charges due the USCs custody purelies from long distance statistic will be convented to fire-juits charge.	padiva	paddro	acquire
(2) The terminating execut charges could be driven down factor than eniginality events charges alone there in proceed receiver presents (or comparison) on eniginating them on terminating scenar (outcomes don't observe the templescen finit calls).	i negative	pasistro	positive
(4) The PCC is constituting remains just an instance universal service from which would be aussied that remains clean consulty expected. Inviting it up so the individual reason to deal with the instance protion of the fund.	negadive	partire.	podin
Nec Nec	Negative	Postava	Nextel, inject that amedic simils an unicipates

This were experient to be an information evaluate to the public. No representation is that it is more an evapore. This preservation is not an effect to buy or sell or a policient on of an effect to buy or sell on a policient with it may have positions in and effect to measurable in more ideas to companies to an effect to make the interest of companies to measurable and may also perform or such as perform investigate facilities or these companies.

CHOM FIZZIN

Equity Resserch Breadpast - Ali Offices Code: A Analyst: Frank J. Governali, CFA industry:Telecom Services Telephone:(207) 780-6210 Date:March 10, 1997

industry:

Telecom Services

Subject:

Mosting with FCC Staff & Chairmen To Discuss Access Reform and Universal Service

Ratingo:

Ne Change

#### Summery

On May 8 the FCC must issue its order on Access Charge Reform and Universal Service funding. The FCC wants to keep the Street's expectations in line with reality, and to insure it is aware of expectations - thus meetings have been conducted with the Street. The FCC is not telling people what it intends to do, but rather reviewing the various options. Our meeting yesterday provided no basis to change our current view on access charge and universal service reform: we continue to believe that access reform will trim annual LEC revenues by \$5 to \$7 billion (not), by the end of a 3 to 5 year transition period. Universal service fund would be \$6 to \$8 billion. Reformed access charges will be comprised of fixed per-line charge, combined with usage sensitive fee.

- Meeting with PCC Staffers with brief visit by Chairman Handt. Yesterday, February 26, we, along with four other sell-siders, met with PCC senior staffers and briefly with Chairman Reed Hundt. The avowed purpose of the meeting was to gauge the expectation of Wall Street to various policy options in the FCC arsenal regarding access reform and universal service. The FCC has been holding these meetings, and will hold others, to ensure it is adequately considering all options in its policy development, and to insure the Street is not in left field as it relates to expected outcomes. This is a smart move by the FCC, of course assuming, federal policy is nor being dietated by stock prices which of course it is not. By May 8 the FCC is required to come up with its order on access charge reform and universal service funding. The task is deunting and the implications profound for the industry. These issues get at the very heart of U.S. telecom policy and will be two of the prime determinants of whether or not competition successfully enters the local arena. (The others are the interconnect rules and the timing of RBOC entry into long distance.)
- \* Hundt Lays Out Policy Principles In Presentation to NARUC On February 25. On Tuesday Chairman Hundt presented and outline of policy priorties and principles to the National Association of Regulated Utility Commissions. It is useful to consider his points, because it was this speech that was the buckdrop for our discussion with the FCC officials on Wednesday. First, Hundt reinforced the notion that access charges need to get down to forward looking sosts. Second, that the recovery of costs had to be done on a basis that encouraged competition and reflected the economic incurrence of costs. Thus, he supported the joint Board recommendation to collect access on both a fixed and variable basis a fixed monthly per line charge combined with a lower usage element. Third, he reconfirmed his position that the LECs should not be assured of fully recovering historic costs in access reform or interconnection. Fourth, he reconfirmed his commitment to a transitional implementation of reduced access charges (not a dislocating flash cut).
- No suggestion of revenue acutral referra of access charges. Recently there have been stories circulating that access reform will end up being a "revenue-neutral" transition for the LECs. We definitely did not hear this yesterday. There can be several interpretations of what revenue neutral means. By our definition, it means that access charges themselves are changed in such a way as to not effect the net revenue collected for access. Thus, based on our discussion yesterday, we continue to believe that access charges will be cut, producing a net reduction in revenue to the LECs on an annual basis of \$5 to \$7 billion by the end of a three to five year transition period. We expect the 1997 cut, and subsequent additional cuts to total \$1 to \$2 billion, adding up to the total \$3 to \$7 billion.

We have not and do not view this level of access cuts to be dramatic. This level of cuts is in line with the revenue reductions absorbed by the LEC industry in their annual price cap adjustments. This level of cuts certainly holds down revenue growth, but it in no way compromises their ability to fund capital investment and maintain the local networks, which is a key concern of regulators and politicians.

The FCC is committed to changing the way access charges are collected. The agency wants to make the method of collection more reflective of the way in which coses are incurred by the LECs. Thus, it wants to get away from collecting the access charges purely on a usage sensitive basis. The FCC is supporting the Joint Board's recommendation to make access charges collection a combination of a fixed monthly per line fee, and a smaller usage sensitive component. Just as access charges today are collected directly from the long distance carriers, these newly formulated access charges will still be collected directly from long distance carriers. And, just as long distance carriers make their own decisions today on how to recover their access costs in pricing to end users, they will do the same in the future. Thus, if the per line charge ends up being \$2 per month for standard telephone lines, (a reasonable level) the long distance carriers would be able to make the choice whether to pass this fee directly to consumers, or to some how mask it in their long distance rates.

- Implications of A Fixed Per Line Charge Combined With a Usage Sensitive Component. The change in the way access charges are collected has positive and negative consequences for both LECs and new entrants. For the LECs, the positive is that it will remove some of the opportunity for competitors to cherry pick high end customers, who generate a lot access revolues through long distance calling. The negative is that with a smaller usage aensitive charge the LECs won't enjoy as much of a revenue pick-up with volume growth. For CAPs the new regime would take away some of the opportunity for cherry picking at the top. But as Reed Hundt said yesterday: "we want to turn CAPs into CLECs" (Competitive Local Exchange Carriers.) The opportunity for CLECs remains undiminished by this change. Similarly, for long distance carriers, eager to become CLECs this change would not be significant. For long distance carriers the key issue is the size of the access revenue cut, not so much its distribution. However, if long distance carriers have to pay a high perline fee, then very low end oustomers become unattractive. If a current pre-subscribed customers makes little to no long distance calls, then the carrier will want to drop this customer, since the revenue might not even cover the per line fee.
- Implications For Stacks. We continue to helieve the growth outlook for the RBOCs is a 3% to 7% growth rate. This is based on the level of access cuts described above, entry into long distance in the second half of 1998, and compatitive pressures starting in the second half of 1997. With this outlook, we think the RBOCs have gotten ahead of themselves recently. On the long distance side, there is no "group call." Its company specific. This is also true for the CLECs. Companies that can operate successfully in the current environment, and transition successfully to full service operators will be winners.

Excerpts From The Chairman's Speech: we've lifted quotes from Reed Hundt's speech below. We think these community can help understand the FCC's current position on a variety of topics.

Pro-Competition ... means we want to promote all competitions and competitive strutegies, even-handedly and indefferently, as opposed to following the United Kingdom model and promoting specifically and unevenly alternative infrastructure development by the cable industry, or a single facilities-based long distance carrier like Mercury

Our choice of being pro-competition instead of being pro-eny specific competitor is why we at the state and federal level are supposed to guarantee all three of the basic rights of new entrants under the Act: buying at wholesale, leasing elements, and interconnecting from new facilities. Effective enforcement of all three rights is necessary to expedite the entry of new compensary into the local exchange and access markets.

Our vigilance in enforcing these rights is essential because the scope of the challenge facing new entants is quite broad. In every single existing service territory the market is dominated by one company - the historic monopolist.

... I think that our target is clear: over time lowering traffic sensitive interstate access charges to forward looking cost and restructuring the cost recovery such that prices charged

We have not and do not view this level of access cuts to be dramatic. This level of cuts is in line with the revenue reductions absorbed by the LEC industry in their annual price cap adjustments. This level of cuts certainly holds down revenue growth, but it in no way compromises their ability to fund capital investment and maintain the local networks, which is a key concern of regulators and politicians.

The FCC is committed to changing the way access charges are collected. The agency wants to make the motitud of collection more reflective of the way in which costs are incurred by the LECs. Thus, it wants to get away from collecting the access charges purely on a usage sensitive basis. The FCC is supporting the Joint Board's recommendation to make access charge collection a combination of a fixed monthly per line fee, and a smaller usage sensitive component. Just as access charges today are collected directly from the long distance carriers, these newly formulated access charges will still be collected directly from long distance carriers. And, just as long distance carriers make their own decisions today on how to recover their access costs in pricing to end users, they will do the same in the future. Thus, if the per line charge ends up being \$2 per month for standard telephone lines, (a reasonable level) the long distance carriers would be able to make the choice whether to pass this fee directly to consumers, or to some how mask it in their long distance rates.

- Implications of A Fixed Per Line Charge Combined With a Usage Sensitive Component. The change in the way access charges are collected has positive and negative consequences for both LECs and new entrants. For the LECs, the positive is that it will remove some of the opportunity for competitors to cherry pick high end customers, who generate a lot access revenues through long distance calling. The negative is that with a smaller usage sensitive charge the LECs won't enjoy as much of a revenue pick-up with volume growth. For CAPs the new regime would take away some of the opportunity for cherry picking at the top. But as Read Hunds said yesterday: "we want to turn CAPs into CLECs" (Competitive Local Exchange Carriers.) The opportunity for CLECs remains undiminished by this change. Similarly, for long distance carriers, cager to become CLECs this change would not be significant. For long distance carriers the key issue is the size of the access revenue cut, not so much its distribution. However, if long distance carriers have to pay a high perline fee, then very low end customers become unattractive. If a current pre-subscribed customers makes little to no long distance calls, than the carrier will want to drop this customer, since the revenue might not even cover the per line fee.
- Implications For Stacks. We continue to believe the growth outlook for the RBOCs is a 3% to 7% growth rate. This is based on the level of access cuts described above, antry into long distance in the second half of 1998, and competitive pressures starting in the second half of 1997. With this outlook, we think the RBOCs have gotten ahead of themselves recently. On the long distance side, there is no "group call." Its company specific. This is also true for the CLECs. Companies that can operate successfully in the current environment, and treasition successfully to full service operators will be winners.

Excerpts From The Chairman's Speech: we've lifted quotes from Reed Hundt's speech below. We think these comments can help understand the FCC's current position on a variety of topics.

Pro-Competition ...means we want to promote all competitiors and competitive strutegies, even-handedly and indefferently, as apposed to following the United Kingdom model and promoting specifically and unevenly alternative infrastructure development by the cable industry, or a single facilities-based long distance carrier like Mercury

Our choice of being pro-competition instead of being pro-eny specific competitor is why we at the state and federal level are supposed to guarantee all three of the basic rights of new antrents under the Act: buying at wholesale, leasing elements, and interconnecting from new facilities. Effective enforcement of all three rights is necessary to expedite the entry of new competitors into the local exchange and access markets.

Our vigilance in enforcing these rights is essential because the scope of the chellenge facing new entents is quite broad. In every single existing service territory the market is dominated by one company - the historic manapolist.

...! think that our target is clear; over time lowering traffic sensitive interstate access charges to forward looking cost and restructuring the cost recovery such that prices charged

competitive market and thus we should seek to emulate this result in the absence of such competition. Where and when the market for a particular access sergice is workably competitive, access prices should be set by them orbit, not by government. The big quustion in access reform is not our target, but how — and how fast—we get there.

This inefficient pricing (of access) discourages broad entry by new entrants (because revenues are concentrated in high volume users) and deters usage of long distance (because is is priced artificially high).

To get from where we are today to where we would like to be, the Joint Board thought we should move some truffic sensitive charges to flet rate charges imposed on IXCs by the LECs. We're calling this the flat and equitable rate charge or FERC...

... We still have to decide how much usage-based charges should be reduced on what we call Day One, the effective date for the changes in our access reform order, and how long we shold take to phase in the rest of the reduction required to get to forward looking costs.

Nor is it obvious that FERC ought to be imposed on all access lines.

In terms of rate levels, we may wish to have different approaches for originating and terminating access charges. There seems to be broad consensus among economists that originating access rates will experience significantly more market pressure than terminating access.

The combined effect of the changes I'm discussing here today is to take a significant step toward gesting access charges to cost immediately, with the bulk of additional reductions coming later, over time.

As to future access reductions, it will be critical to set in motion a predictable process in our order that will reduce access to forward looking economic cost within a reasonable time period.

... we also intend to address the question of LEC recovery of historic costs... I do not believe however, that we shall diegin the inquiry into the historic cost issue with the supposition that the LEC is necessarily guaranteed as a matter of law a complete certainty of recovering at such investment. Takings is certainly one of our concerns here, but we must not forget "givings". Let me mention three: first, giving the LECs cellular licenses worth billions; second, giving LECs yellow pages publishing opportunities (also worth billions); and third giving LECs the opportunity to anier long distance, where they can leverage their regulated local asset.

This memoranish is for informative purposes only. Under no circumstages in it to be used or considered as an other to sell, or a collection of any other to buy, any considered to information deviation of several form obtained to be reliable, we do not represent the it is accessed or complete and it should not be reliable, used to not represent the it is accessed or complete and it should not be reliable properties of several to formit. This firm may from time to the processor building at other at other parties for an accessed in the region.

So that it is not considered to the region.

Equity Research Breadcast - Ali Offices Code: A Analyst: Frank J. Governali, CFA industry:Telecom Services Telephone:(207) 780-6210 Date:March 10, 1997

industry:

Telecom Services

Subject:

Moeting with FCC Staff & Chairmen To Discuss Access Reform and Universal Service

Ratings:

No Change

#### Summery

On May 8 the FCC must issue its order on Access Charge Resonn and Universal Service funding. The FCC wants to keep the Street's expectations in line with reality, and to insure it is aware of expectations - thus meetings have been conducted with the Street. The FCC is not telling people what it intends to do, but rather reviewing the various options. Our meeting yesterday provided no basis to change our current view on access charge and universal service reform: we continue to believe that access resorm will trim annual LEC revenues by 55 to 57 billion (not), by the end of a 3 to 5 year transition period. Universal service fund would be \$6 to \$8 billion. Reformed access charges will be comprised of fixed per-line charge, combined with usage sensitive fee.

- Meeting with PCC Staffers with brief visit by Chairman Handt. Yesterday, February 26, we, along with four other sell-siders, met with PCC senior staffers and briefly with Chairman Reed Hundt. The avouad purpose of the meeting was to gauge the expectation of Wall Street to various policy options in the PCC arsenal regarding access reform and universal service. The PCC has been holding these meetings, and will hold others, to ensure it is adequately considering all options in its policy development, and to insure the Street is not in left field as it relates to expected outcomes. This is a smart move by the PCC, of course assuming, federal policy is not being dictated by stock prices which of course it is not. By May 8 the PCC is required to come up with its order on access charge reform and universal service finding. The task is daunting and the implications profound for the industry. These issues get at the very heart of U.S. telecompolicy and will be two of the prime determinants of whether or not competition successfully enters the local arena. (The others are the interconnect rules and the timing of RBOC entry into long distance.)
- Hundt Lays Out Policy Principles In Presentation to NARUC On February 25. On Tuesday Chairman Hundt presented and outline of policy priorties and principles to the National Association of Regulated Utility Commissions. It is useful to consider his points, because it was this speech that was the backdrop for our discussion with the FCC officials on Wednesday. First, Hundt reinforced the notion that access charges need to get down to forward looking costs. Second, that the recovery of costs had to be done on a basis that encouraged competition and reflected the economic incurrence of cost. Thus, he supported the joint Board recommendation to collect access on both a fixed and variable basis a fixed monthly per line charge combined with a lower usage element. Third, he reconfirmed his position that the LECs should not be assured of fully recovering historic costs in access reform or interconnection. Fourth, he reconfirmed his commitment to a transitional implementation of reduced access charges (not a dislocating flush cut).
- No suggestion of revenue neutral reform of access charges. Recently there have been stories circulating that access reform will end up being a "revenue-neutral" transition for the LECs. We definitely did not hear this yesterday. There can be several interpretations of what revenue neutral means. By our definition, it means that access charges themselves are changed in such a way as to not effect the net revenue collected for access. Thus, based on our discussion yesterday, we continue to believe that access charges will be cut, producing a net reduction in revenue to the LECs on an annual basis of \$5 to \$7 billion by the end of a three to five year transition period. We expect the 1997 cut, and subsequent additional cuts to total \$1 to \$2 billion, adding up to the total \$5 to \$7 billion.

We have not and do not view this level of access cuts to be dramatic. This level of cuts is in line with the revenue reductions absorbed by the LEC industry in their annual price cap adjustments. This level of cuts certainly holds down revenue growth, but it in no way compromises their ability to fund capital investment and maintain the local networks, which is a key concern of regulators and politicians.

The FCC is committed to changing the way access charges are collected. The agency wants to make the method of collection more reflective of the way in which costs are incurred by the LECs. Thus, it wants to get away from collecting the access charges purely on a usage sensitive basts. The FCC is supporting the Joint Board's recommendation to make access charge collection a combination of a fixed monthly per line fee, and a smaller usage sensitive component. Just as access charges today are collected directly from the long distance certiers, these newly formulated access charges will still be collected directly from long distance carriers. And, just as long distance carriers make their own decisions today on how to recover their access costs in pricing to end users, they will do the same in the future. Thus, if the per line charge ends up being 52 per month for standard telephone lines, (a reasonable level) the long distance carriers would be able to make the choice whether to pass this fee directly to consumers, or to some how mask it in their long distance rates.

- Implications of A Fixed Per Line Charge Combined With a Usage Sensitive Component. The change in the way access charges are collected has positive and negative consequences for both LECs and new entrants. For the LECs, the positive is that it will remove some of the opportunity for competitors to cherry pick high end customers, who generate a lot access revolues through long distance calling. The negative is that with a smaller usage centitive charge the LECs won't enjoy as much of a revenue pick-up with volume growth. For CAPs the new regime would take away some of the opportunity for cherry picking at the top. But as Reed Hundt said yesterday: "we want to turn CAPs into CLECs" (Competitive Local Exchange Carriers.) The opportunity for CLECs remains undiminished by this change. Similarly, for long distance curriers, eager to become CLECs this change would not be significant. For long distance carriers the key issue is the size of the access revenue cut, not so much its distribution. However, if long distance carriers have to pay a high perline fee, then very low end oustomers become unattractive. If a current pre-subscribed customers makes little to no long distance calls, then the carrier will want to drop this customer, since the revenue might not even cover the per line fee.
- Implications For Stacks. We continue to believe the growth outlook for the RBOCs is a 3% to 7% growth rate. This is based on the level of access cuts described above, entry into long distance in the second half of 1998, and competitive pressures starting in the second half of 1997. With this outlook, we think the RBOCs have gotten ahead of themselves recently. On the long distance side, there is no "group call." Its company specific. This is also true for the CLECs. Companies that can operate successfully in the current environment, and transition successfully to full service operators will be winners.

Excerpts From The Chairman's Speech: we've lifted quotes from Reed Hundt's speech below. We think these comments can help understand the FCC's current position on a variety of topics.

Pro-Competition ... means we want to promote all competitiors and competitive strutegies. even-handedly and indeliferently, as opposed to following the United Kingdom model and promoting specifically one unevenly alternative infrastructure development by the cable industry, or a single facilities-based long distance carrier like Mercury

Our choice of being pro-competition instead of being pro-eny specific competitor is why we at the state and federal level are supposed to guarantee all three of the basic rights of new entrants under the Act: buying at wholesale, leasing elements, and interconnecting from new facilities. Effective enforcement of all three rights is necessary to expedite the entry of new compensary into the local exchange and access markets.

Our vigilance in enforcing these rights is essential because the scope of the challenge facing new entents is quite broad. In every single existing service territory the market is dominated by one company - the historic monopolist.

...! think that our surget is clear: over time lowering traffic sensitive interstate access charges to forward looking cost and restructuring the cost recovery such that prices charged

We have not and do not view this level of access cuts to be dramatic. This level of cuts is in line with the revenue reductions absorbed by the LEC industry in their annual price cap adjustments. This level of cuts certainly holds down revenue growth, but it in no way compromises their ability to fund capital investment and maintain the local networks, which is a key concern of regulators and politicians.

The FCC is committed to changing the way access charges are collected. The agency wants to make the motitod of collection more reflective of the way in which sosts are incurred by the LECs. Thus, it wants to get away from collecting the access charges purely on a usage sensitive basis. The FCC is supporting the Joint Board's recommendation to make access charge collection a combination of a fixed monthly per line fee, and a smaller usage sensitive component. Just as access charges today are collected directly from the long distance carriers, these newly formulated access charges will still be collected directly from long distance carriers. And, just as long distance carriers make their own decisions today on how to recover their access costs in pricing to end users, they will do the same in the future. Thus, if the per line charge ends up being \$2 per month for standard telephone lines, (a reasonable level) the long distance carriers would be able to make the choice whether to pass this fee directly to consumers, or to some how mask it in their long distance rates.

- Implications of A Fixed Per Line Charge Combined With a Usage Sensitive Component. The change in the way access charges are collected has positive and negative consequences for both LECs and new entrants. For the LECs, the positive is that it will remove some of the opportunity for competitors to cherry pick high end customers, who generate a lot access revenues through long distance culling. The negative is that with a smaller usage sensitive charge the LECs won't enjoy as much of a revenue pick-up with volume growth. For CAPs the new regime would take away some of the opportunity for cherry picking at the top. But as Read-Hundt said yesterday: "we want to turn CAPs into CLECs" (Competitive Local Exchange Carriers.) The opportunity for CLECs remains undiminished by this change. Similarly, for long distance carriers, eager to become CLECs this change would not be significant. For long distance carriers the key issue is the size of the access revenue cut, not so much its distribution. However, if long distance carriers have to pay a high perline fee, then very low end customers become unattractive. If a current pre-subscribed customers makes little to no long distance calls, than the carrier will want to drop this customer, since the revenue might not even cover the per line fee.
- Implications For Stocks. We continue to believe the growth outlook for the RBOCs is a 3% to 7% growth rate. This is based on the level of access cuts described above, entry into long distance in the second half of 1998, and competitive pressures starting in the second half of 1997. With this outlook, we think the RBOCs have gotten ahead of themselves recently. On the long distance side, there is no "group call." Its company specific. This is also true for the CLECs. Companies that can operate successfully in the current environment, and transition successfully to full service operators will be winners.

Excerpts From The Chairman's Speech: we've lifted quotes from Reed Hundt's speech below. We think these comments can help understand the FCC's current pacition on a variety of topics.

Pro-Competition ...means we want to promote all competitiors and competitive strutegies, even-handedly and Indelfferently, as opposed to following the United Kingdom model and promoting specifically and unevenly alternative infrastructure development by the cable industry, or a single facilities-based long distance carrier like Mercury

Our choice of being pro-competition instead of being pro-eny specific competitor is why we at the state and federal level are supposed to guarantee all three of the basic rights of new entrants under the Act: buying at wholesale, leasing elements, and interconnecting from new facilities. Effective enforcement of all three rights is necessary to expedite the entry of new competitors into the local exchange and access markets.

Our vigilance in enforcing these rights is essential because the scope of the challenge facing new entants is quite broad. In every single existing service territory the market is dominated by one company - the historic manapolist.

...! think that our target is clear; over time lowering traffic sensitive interstate access charges to forward looking cost and restructuring the cost recovery such that prices charged

competitive market and thus we should seek to emulate this result in the absence of such competition. Where and when the market for a particular access sergice is workably competitive, access prices should be set by them orket, not by government. The big quustion in access reform is not our target, but how — and how fast—we get there.

This inefficient pricing (of access) discourages broad entry by new entrants (because revenues are concentrated in high volume users) and deters usage of long dissumes (because is is priced artificially high).

To get from where we are today to where we would like to be, the Jaint Board thought we should move some traffic sensitive charges to flat rute charges imposed on IXCs by the LECs. We're calling this the flat and equitable rate charge or FERC...

... We still have to decide how much usage-based charges should be reduced on what we call Day One, the effective date for the changes in our access reform order, and how long we shold take to phase in the rest of the reduction required to get to forward looking costs.

Nor is it obvious that FERC ought to be imposed on all access lines.

In terms of rate levels, we may wish to have different approaches for originating and terminating access charges. There seems to be broad consensus among economists that originating access rates will experience significantly more market pressure than terminating access.

The combined effect of the changes I'm discussing here todayls to take a significant step toward gasting access charges to cost immediately, with the bulk of additional reductions coming later, over time.

As to future access reductions, it will be critical to set in motion a predictable process in our order that will reduce access to forward looking economic cost within a reasonable time period.

...we also intend to address the question of LEC recovery of historic costs...! do not believe however, thus we shall begin the inquiry into the historic cost issue with the supposition that the LEC is necessarily guaranteed as a matter of law a complete certainty of recovering at such investment. Takings is certainly one of our concerns here, but we must not forget "givings". Let me mention three: first, giving the LECs cellular licenses worth billions; second, giving LECs yellow pages publishing opportunities (also worth billions); and third giving LECs the opportunity to unter long distance, where they can leverage their regulated local asset.

Equity Research Breadcast - All Offices Code: A Analyst: Frank J. Governali, CFA Industry: Telecom Services Telephone: (207) 780-6210 Date: March 10, 1997

Industry:

Telecom Services

**Subject:** 

Meeting with FCC Staff & Chairman To Discuss Access Reform and Universal Service

Ratings:

No Change

#### Summer

On May 8 the FCC must issue its order on Access Charge Reform and Universal Service funding. The FCC wants to keep the Street's expectations in line with reality, and to insure it is aware of expectations - thus meetings have been conducted with the Street. The FCC is not telling people what it intends to do, but rather reviewing the various options. Our meeting yesterday provided no basis to change our current view on access charge and universal service reform: we continue to believe that access reform will trim annual LEC revenues by \$5 to \$7 billion (not), by the end of a 3 to 5 year transition period. Universal service fund would be \$6 to \$8 billion. Reformed access charges will be comprised of fixed per-line charge, combined with usage sensitive fee.

- Meeting with PCC Staffers with brief visit by Chairman Hundt. Yesterday, February 26, we, along with four other tell-siders, mot with FCC senior staffers and briefly with Chairman Reed Hundt. The avowed purpose of the meeting was to gauge the expectation of Wall Street to various policy options in the FCC arsenal regarding access reform and universal service. The FCC has been holding these meetings, and will hold others, to ensure it is adequately considering all options in its policy development, and to insure the Street is not in left field as it relates to expected outcomes. This is a smart move by the FCC, of course assuming, federal policy is not being dictated by stock prices which of course it is not. By May 8 the FCC is required to come up with its order on access charge reform and universal service funding. The task is deunting and the implications profound for the industry. These issues get at the very heart of U.S. telecompolicy and will be two of the prime determinants of whether or not competition successfully enters the local arena. (The others are the interconnect rules and the timing of RBOC entry into long distance.)
- Hundt Lays Out Policy Principles In Presentation to NARUC On February 25. On Tuesday Chairman Hundt presented and outline of policy priorties and principles to the National Association of Regulated Utility Commissions. It is useful to consider his points, because it was this speech that was the backdrop for our discussion with the FCC officials on Wednesday. First, Hundt reinforced the notion that access charges need to get down to forward looking costs. Second, that the recovery of costs had to be done on a basis that encouraged competition and reflected the economic incurrence of costs. Thus, he supported the joint Board recommendation to collect access on both a fixed and variable basis a fixed monthly per line charge combined with a lower usage element. Third, he reconfirmed his position that the LECs should not be assured of fully recovering historic costs in access reform or interconnection. Fourth, he reconfirmed his commitment to a transitional implementation of reduced access charges (not a dislocating flash cut).
- No suggestion of revenue neutral reform of access charges. Recently there have been stories circulating that access reform will and up being a "revenue-neutral" transition for the LECs. We definitely did not hear this yesterday. There can be several interpretations of what revenue neutral means. By our definition, it means that access charges themselves are changed in such a way as to not effect the net revenue collected for access. Thus, based on our discussion yesterday, we continue to believe that access charges will be cut, producing a net reduction in revenue to the LECs on an annual basis of \$5 to \$7 billion by the end of a three to five year transition period. We expect the 1997 cut, and subsequent additional cuts to total \$1 to \$2 billion, adding up to the total \$5 to \$7 billion.